**APPLICATION OF**

**RESTON LAKE ANNE AIR CONDITIONING CORPORATION** **CASE NO. PUE980139**

**For an increase in rates**

# REPORT OF DEBORAH V. ELLENBERG, CHIEF HEARING EXAMINER

**July 16, 1999**

On April 22, 1998, Reston Lake Anne Air Conditioning Corporation ("RELAC" or "the Company") filed an application requesting an increase in its rates for metered service effective for service rendered on and after May 22, 1998. The Company requested an increase in its annual revenues of $28,332. The Company acknowledges that the proposed rates result in a 60% increase in metered rates. The Company proposes no increase to its flat rate service.

By order dated May 1, 1998, the Commission required the Company to notify each of its customers of its proposal and scheduled a public hearing for October 22, 1998.

On July 14, 1998, Fairfax County filed a motion to move the venue of the hearing to Fairfax County in order to better accommodate the concerns of affected customers who would not otherwise be able to participate if the hearing were held as scheduled in Richmond. By ruling dated July 28, 1998, that motion was granted in part. A public hearing was scheduled for October 1, in Fairfax County for the purpose of hearing from public witnesses. Eight customers appeared at that hearing and generally expressed a common concern that the proposed increase was applied only to metered customers.

On September 9, 1998, a motion was filed by Monroe Freeman, a Protestant in this case, to postpone the October 22 hearing scheduled to be heard in Richmond. Mr. Freeman later withdrew his request.

On October 22, 1998, a second hearing was convened in Richmond. Paul B. Ward, Esquire, appeared as counsel for the Company; Marta B. Curtis, Esquire, and Allison L. Held, Esquire, appeared as counsel to the Commission; Dennis R. Bates, Esquire, appeared on behalf of the Fairfax County Board of Supervisors; and Monroe E. Freeman, Jr. appeared *pro se*. Additionally, David Keever offered testimony as a public witness at the Richmond hearing.

Proof of the required notice was marked as Exhibit A and admitted into the record. Transcripts of the hearings are filed with this Report.

The Company and Fairfax County subsequently filed Post-Hearing Memoranda.

## SUMMARY OF THE RECORD

RELAC provides chilled water service for air conditioning to 249 condominium units, 338 townhouses, 1 church, and 17 commercial spaces in a planned community in Reston, Virginia.[1] This novel utility was conceived and placed in service by Gulf Reston, the developer of the community, to provide a means of air conditioning the community without placing individual air conditioning units outside each building.[2]

The Company produces chilled water at a central air conditioning plant which operates continuously 24 hours a day from May 22 through October 9 of each year. The plant contains four (4) 4.8 million British Thermal Units per Hour ("BTUH") capacity chillers.[3] The chilled water is distributed from the plant to customers for use in cooling their residences. Inside the residence, a fan blows air across the chilled water as it passes through an air conditioning coil and produces cool air. After the water is used, it flows out of the residence into a return line and back to the air conditioning plant to be cooled back down to a range of 43º to 51º Fahrenheit.[4]

In 1979 Donatelli and Klein, Inc., ("Donatelli and Klein") a Maryland corporation, acquired approximately $40 million in property and assets in Reston, Virginia, from Gulf Reston. The property was served by, and the acquisition included, the air conditioning plant.[5] RELAC was incorporated on November 7, 1979, and began operation of the utility plant in 1980.[6]

In November 1983, HOLDAC, a company wholly owned by Douglas and Barbara Cobb purchased RELAC. Mr. Cobb testified that Donatelli and Klein verbally agreed to pay $250,000 to the Cobbs for which the Cobbs would assume operation of the plant and the outstanding liability of the utility in an antitrust proceeding[7] instituted against the utility by several owners, a maximum liability of $3 million.[8] Mr. Cobb testified that during negotiations, he and his wife agreed to take the parcel of land on which the air conditioning plant was located as partial payment in lieu of $175,000.[9]

By the terms of the written agreement, HOLDAC received the right to pump water from Lake Anne, the real property on which the utility plant is located, and a contribution of $75,000 to the capital of the utility.[10]

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[1]Ex. DAC-2, at 1

[2]Ex. LCM-7, at 1-2; JAS-8, at 3

[3]Ex. JAS-8, at 3.

[4]Id. at 3-4.

[5]Mr. Cobb asserts that the plant was "slipped" into the deal and was in horrible condition. (Ex. DAC-2, at 1).

[6]Ex. LCM-7, at 2.

[7]Civil Action No. 83-0932-A in the U. S. District Court for the Eastern District of Virginia.

[8]Ex. DAC-2, at 1-2

[9]*Id*.

[10]*Id.* at Att. 1.

In 1985, HOLDAC was dissolved and the real property on which the utility plant is located was transferred at no additional cost to Mr. and Mrs. Cobb.[11]

In the pending application, the Company proposes to increase only its metered service rates, the Company proposes no change to the unmetered rates. When the application was filed, 157 of the residential customers received service under the metered rate schedule[12] and the remaining customers were receiving service under the unmetered rate schedule. All but one commercial customer were receiving service under an unmetered rate schedule.[13] Thus, approximately seventy-four percent of the customer base is unmetered.

The current flat or unmetered rate schedule is based on an established BTUH load schedule that assigns a BTUH load to each unit. BTUH loads are calculated in accordance with the American Society of Heating, Refrigeration and Air Conditioning Engineer's Handbook of Fundamentals.[14] The calculation is a measure of the BTU's absorbed by a residence during one hour of a typical air conditioning season.[15] The current unmetered rates are $30.30 per 2,000 BTUH or a portion thereof for residential customers and $38.76 for commercial users per season.[16]

[11]Ex. LCM-7, at 2.

[12]Historically RELAC offered all service for a flat contract or unmetered rate. In 1983 the Commission authorized the Company to permit the installation of meters. (*Application of Reston/Lake Anne Air Conditioning Corporation*, Case No. PUE830009, 1983 S.C.C. Ann. Rep. 450, Hearing Examiner Report dated May 6, 1983). In 1984 the Commission granted RELAC's request to offer an experimental rate for metered use. (*Application of Reston/Lake Anne Air Conditioning Corporation*., Case No. PUE840012, 1984 S.C.C. Ann. Rep. 476). The Commission later ordered that metering on a voluntary basis be established as a permanent part of the Company's rate structure. *(Application of Reston/Lake Anne Air Conditioning Corporation*., Case No. PUE890085, 1990 S.C.C. Ann. Rep. 316, Hearing Examiner Report dated June 4, 1990, at 4-6).

[13]Ex. JAS-8, at 3.

[14]*Id.* at 7.

[15]The calculation factors in a number of considerations that affect heat absorption of a structure, such as the number of doors and windows in a building, shading from surrounding structures, and insulation.

[16]Ex. JAS-8, at 13.

The Company's previous and proposed metered rates are as follows:

| **Non-interruptible Rates and Charges for Metered Service:** | **Current** | **Proposed** |
|---|---|---|
| The minimum charge per billing period[17] for metered customers payable regardless of usage, but credited against actual usage | $27.00 | $54.00 |
| Per 1,000 gallons for the 1st 10,000 gallons used in each billing period | $ 5.60 | $ 8.96 |
| Per 1,000 gallons for each 1,000 gallons or part thereof used in excess of 10,000 gallons in each billing period | $ 2.80 | $ 4.48 |

In support of its application, the Company presented the testimony of its president, Douglas A. Cobb.[18] Mr. Cobb prepared a cost of service study to derive the proposed rates in this case. In that study Mr. Cobb allocated costs between metered and unmetered customer classes. Costs were separated into variable and fixed categories. The variable costs fluctuate with changes in output.[19] In the Company's study, the variable costs included only electric and gas costs and accounted for 28% of total costs. The fixed costs included the remaining operating and maintenance costs and accounted for 72% of total costs.[20]

The Company next developed allocation factors for both cost categories to apportion costs to the metered and unmetered customer classes. The allocation factors were based on the ratio of the Company's total variable costs in 1984 to the total BTUH load in that year. That year was used because it was the last season in which all customers were still served on an unmetered rate schedule.[21] The ratio was applied to the total BTUH load of each class of customers (metered and non-metered) in 1997 to first calculate the estimated variable costs attributable to each class during the test period. The Company's variable cost allocation factor allocates 21.14% of its variable costs to metered customers and the remaining 78.86% to unmetered customers.[22]

The Company's fixed cost allocation factor distributed 37.1% of fixed costs to metered customers and the remaining 62.9% to unmetered customers.[23] The results of the Company's study

[17]The metered rate schedule provides for four billing periods per cooling season.

[18]Exs. DAC-1 and 2.

[19]Ex. JAS-8, at 4-5.

[20]*Id.*

[21]*Id.*

[22]*Id.* at 6.

[23]*Id.*

indicate that metered rates are not producing sufficient revenues to cover the costs associated with serving those customers.

Eight public witnesses testified in opposition to the increase at the October 1 local hearing. Lothair Rowley observed that the cost to air condition his home last year was $211.75, exclusive of the cost of the electricity to run the blower.[24] He stated that his bill would climb to $355.80 with the proposed increase.[25] He testified that the Company proposal encourages customers to switch back to unmetered service. He observed that with metered rates he has had an incentive to do a number of things to increase the energy efficiency of his home. He observed that unmetered customers do not have an incentive or receive credit for such efforts. Mr. Rowley complained that the cost for service from RELAC is high, the quality of service is poor, and the proposed allocation of the entire increase to metered customers discourages energy efficient improvements and use. He recommended that all customers be placed on meters.[26]

Herman Lazerson supported Mr. Rowley's position. In Mr. Lazerson's opinion, the Company's proposed rate design is a "blatant request to discourage conservation and to force meter users to the fixed rate and encourages waste."[27] Mr. Lazerson asserts that existing rates are excessive.[28] He asked the Commission to reject the proposed increase, investigate the existing rates and if found to be excessive, to order refunds, require RELAC to meter all customers, and declare that RELAC customers are free to choose alternative air conditioning providers.[29]

Ms. Lisa Climo also offered public testimony on the proposed rate design. She was surprised that the Company had not been able to provide data on total gallons used by the system and urged the Commission to require that data before any decision was made on which class of customers was imposing costs on the system. She also questioned the level of salary paid to Mr. Cobb. She emphasized that the RELAC charge is only one portion of the total air conditioning cost to a family since there is also a charge for the electricity needed to operate the blower. She expressed dismay that the covenants require a two-thirds vote to move off the RELAC system.

Edward T. Climo, Jr. added testimony that the Company has never documented what the actual cost of serving the metered customers is, nor compared that cost to its total cost.[30] He observed that many costs, such as the cost of water lost through leakage is unknown. He too expressed concern that forcing customers to the flat rate discouraged energy conservation. Finally, he challenged the Company's methodology for calculating BTUH loads.

Willard Fraize testified next. He had been a metered customer since metered service was offered, but he was now a contract or unmetered customer due to the proposed change in the rates.

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[24] Tr. 8.

[25] *Id.* at 9.

[26] *Id.*

[27] Tr. 12.

[28] *Id.* at 15.

[29] *Id.*

[30] *Id.* at 20.

He noted that it was cheaper for him to take contract service than metered service. He enjoyed the uniqueness of the system and recognized that there is a cost to maintaining the system regardless of his use. He supports the notion that all customers should be on metered service to facilitate charges for usage, and seeks a determination of the cost basis that is proper and fair.[31]

Geraldine Shaw expressed support for the testimony of those witnesses who preceded her. She also expressed frustration that RELAC did not know how much air conditioning the unmetered customers were using.[32]

Wayne Schiffelbein took the time to explain the formula used to calculate BTUH usage on the system. He noted that a very sophisticated formula takes into account the location of a building, the size of all openings, what the openings are filled with, and structural shading from surrounding buildings, but does not account for landscape shading. He observed that some of the homes now have very mature landscaping and therefore probably receive much less solar radiant heat than the formula would show.[33]

Mr. Schiffelbein identified a problem with variance in the water temperature. Meters do not measure the temperature of the water, but rather only the water flow. He observed that the cooling effect across the coil and dehumidification are vastly different if the water temperature is 42 or 62 degrees.[34] He noted that problems with the water temperature are compounded at his residence because the water supply to his house passes through three pump rooms owned, not by the utility, but by the owners of the condominiums.

Mr. Schiffelbein also opined that the utility's costs were too high relative to a small customer base. He observed that whatever virtues it was believed the chilled air conditioning system possessed when it was placed in service, it is now generally recognized that the system was a bad idea. He testified that it is unreasonable to burden residential customers with air conditioning costs significantly above normal levels for the region.

Last to testify at the first hearing was Maria Prybyla who has lived in two separate homes on the RELAC system over the last 32 years. She testified that the system appeared to be failing before Mr. Cobb took it over, but that he then did a fantastic job refurbishing it. At the same time she saw the rates climb, and at one point could not take air conditioning service for two years because of the cost. She expressed her support for the institution of meters so that customers could take what they were willing to pay for. She noted that the air conditioning at her home is run continually and her highest bills have been close to $900 as compared to the contract rate for her home which would have been $1,503. She however expressed concern with the 60% proposed increase and supported the testimony of those witnesses who preceded her.[35]

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[31] *Id.* at 25-29.

[32] *Id.* at 31.

[33] Tr. 35-36.

[34] *Id.* at 37.

[35] *Id.* at 47.

David Keever, president of the Hickory Cluster Association Board of Directors, offered public testimony at the beginning of the Richmond hearing. He noted several concerns.[36] First, he asserted that the proposed increase was excessive in a one-year adjustment. Second, he expressed concern with the some of the fixed costs, such as salaries and benefits costs. Third, he testified that the BTUH calculation does not account for changes and improvements that have occurred in the 30-year old neighborhood. Finally, he noted his concern for the long-term technical viability of the system.[37]

In summary, all public witnesses were opposed to the increase and particularly with application of the increase solely to the metered customers. They generally noted that such a rate design would serve to discourage rather than encourage energy conservation.

Mr. Freeman participated in this case as a Protestant, and testified on his own behalf. He is a metered customer and also challenges the proposed rate design. Specifically, he was concerned that RELAC proposed to allocate costs to the metered customers based on their maximum potential usage, the BTUH analysis, rather than actual usage.[38] He asserts that most customers, and certainly he, would be better off without the utility and he argued that he could air condition his home less expensively with an individual unit. He acknowledges that the restrictive covenants in the development preclude him from installing his own air conditioning unit. Thus, he recognized that while the customers are subject to the restrictive covenants, the issue which must be addressed in this case is the appropriate allocation of costs between the two classes of customers.[39]

Fairfax County offered the testimony of Denise S. Gould, a utilities analyst for the County. She recommended that the Commission carefully investigate the operating expenses that contributed to the rate increase.[40] She also testified that she reviewed the cost of service analysis submitted by the Company and found it to support allocating the full increase to the metered service. The increase, however, she asserts, is so dramatic that it will shock most of the affected customers.[41] Ms. Gould argues that the 60% increase to the metered rates would result in an annual increase of $180.45 for the average residential metered customer.[42] The proposed rates would appear to force 35 customers with metered service to flat rate service.[43] She recommends that the proposed increase be phased in over three years. Such an incremental increase will minimize rate shock, but provide revenue stability for the Company.[44]

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[36]Tr. 64.

[37]*Id.* at 65.

[38]Ex. MEF-11, at 1-2; Tr. 62.

[39]Ex. MEF-11, at 1.

[40]Ex. DSG-10, at 3.

[41]*Id.* at 9.

[42]*Id.* at 10.

[43]*Id.*, Schedule 1.

[44]*Id.* at 10.

Ms. Gould also testified that metered rates should not be abandoned. Elimination of metered service could force low volume or periodic users to drop off the system entirely, and further, would discourage energy conservation, efficient use of service and customer choice.[45]

Staff filed the testimony of Lynn C. Miller, a senior public utility accountant with the Commission Division of Public Utility Accounting[46] and John A. Stevens, a utilities engineer with the Commission Division of Energy Regulation.[47] Although both accounting and rate design issues remained in controversy in this proceeding, Staff takes issue only with accounting issues. Specifically, the Company and Staff disagree with regard to the calculation of revenues, rent expense for the land that the Cobbs own and rent to the utility, and employee medical benefits.

First, Staff annualized revenue based on customer base towards the end of the test period. On expenses, Ms. Miller testified that the cost of service should not include rent expenses paid to the Cobbs. Staff asserts that the Cobbs received the property at no cost, and that the Commission previously has determined affiliate expenses allowed for ratemaking must be based on the affiliate's costs, including a reasonable return, so long as the cost does not exceed the market price.[48] Hence, if the Cobbs' cost for the land was zero, no rent expense is allowable in rates. Staff also opposes the Company's proposal to reimburse its employees for medical copayments for prescriptions and include those payments in the Company's cost of service.[49] Staff also made several booking recommendations.[50] Staff recommends an increase in revenues of $14,516 to produce a total operating revenue of $315,291 and operating income of $16,054.[51]

Mr. Stevens initially opposed the Company's rate design which applied the entire increase to metered customers. He revised his testimony prior to the hearing, however, and now supports the rate design proposed by Fairfax County and accepted by the Company in rebuttal testimony. Staff recommends therefore that the increase approved by the Commission be apportioned to the metered customer class, but phased in over a three-year period to mitigate rate shock to that class of customers.[52]

As part of his analysis, Staff witness Stevens reviewed the Company's cost of service study. He determined that additional costs should be treated as variable. Mr. Stevens assigned 41.7% of the Company's costs to the variable category and 58.3% of the costs to the fixed category.[53] He also testified that without actual data, the Company's traditional BTUH class allocation formula

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[45] *Id.* at 11.

[46] Ex. LCM-7.

[47] Ex. JAS-8.

[48] Ex. LCM-7, at 7.

[49] *Id.* at 4.

[50] Ex. LCM-7, at 8.

[51] Ex. LCM-7, at 8 ,and Statement I Revised; Tr. 59.

[52] Ex. JAS-9; Tr. 148.

[53] Ex. JAS-8, at 7-8.

was acceptable.[54] Mr. Stevens' differences from the Company, however, did not impact their agreement that any increase should be allocated to the metered customers over three years.[55]

## DISCUSSION

*Revenues*

Staff increased revenue to reflect customer base as of the end of the test period.[56] In rebuttal testimony, the Company took exception to Staff's adjustment to revenue. Mr. Cobb argued that the last billing data available to Staff was from the October not the December end of test period bills. He contends that to increase revenue by extrapolating the customer levels from the October billing assumes that no one will move out. He testified that Staff's adjustment suggests customer levels at the beginning of the test year were lower than the average annual occupancy. In his opinion, 1997 average occupancy for the test period is more reflective of expected revenue.[57] He asserts that his personal observation indicates approximately the same level of occupancy year in and year out.[58]

Staff, however, routinely updates customer base to reflect the most current information available. Staff's adjustment is consistent with the Commission's practice of incorporating the most current available customer information in the calculation of revenue levels. Although rates traditionally are based on historic test periods, the Commission seeks current, actual, audited data when appropriate. Here, Staff's adjustments to reflect October customer levels is based on the most current actual audited data. Moreover, there is no evidence of unusual seasonal fluctuations which might indicate use of the October level would cause a distortion in the customer level. Staff's adjustment is reasonable and should be used.

*Rent Expense*

Mr. and Mrs. Cobb charge RELAC $15,600 annually to rent the land on which the utility plant is located. That rental charge provides a return to the Cobbs on the assessed value of the land of approximately 10%.[59] The Cobbs are "affiliates of the Company" as defined in Va. Code § 56-78, and thus recovery in rates of any expenses paid to the Cobbs is subject to closer scrutiny. Virginia Code § 56-78 provides that the Commission may exclude payments to affiliates if such payments are not consistent with the public interest. Staff and Fairfax County assert that the Company has not met the test for recovery that has been articulated by the Commission.[60] The Company argues that it has met its burden and is entitled to recover that rent expense in rates.[61]

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[54] *Id.*

[55] *Id.*

[56] Ex. LCM-7, at 4.

[57] Ex. DAC-2, at 2.

[58] *Id.*

[59] Ex. LCM-7, at 7.

[60] Ex. LCM-7, at 7, Fairfax County Brief at 2.

[61] Ex. DAC-2, at 2-3.

Prior to the Cobbs' ownership, the utility paid $1,200 annually to rent the land. In 1984, after the Cobbs acquired the utility, and continuing through 1990, RELAC paid $12,000 in annual rent. In 1991, the rent expense charged RELAC increased to $15,600.[62] Although the Company paid rent in the amount of $15,600 in 1991 and that level continued to be set forth in the affiliate lease approved by the Commission, the Company actually paid no rent in 1992, $11,700 in 1993, and $7,800 in 1997 and 1998. The full rent of $15,600 was paid in 1994, 1995 and 1996.[63]

The Commission has regularly reviewed and approved the lease agreement between RELAC and the Cobbs. The Company asserts that in four previous cases it has received approval to lease the land from an affiliate. In all cases the lease clearly provides an annual rent of $15,600.[64] Indeed, in 1995, the Commission granted the Company approval to renew the property lease agreement with the Cobbs "under the same terms and conditions and for the purposes as previously authorized."[65]

The Commission, however, clearly stated that the approval granted should not be deemed to guarantee the recovery of any costs or charges for ratemaking purposes and that RELAC would bear the burden of proof that such costs were fair and reasonable.[66]

The Commission often has addressed affiliate expenses. In 1997 the Commission held that "[w]here the Company proposes that the Commission set rates based on charges from an affiliate, the charges must be based on the affiliate's cost, including a reasonable return, so long as this cost does not exceed the market price."[67] It is in reliance on this case that Staff disallows the rent expense for ratemaking. Staff asserts that the Cobbs should not earn a return on the assessed value of the land since they obtained the property at no cost.[68] Staff, however, included property taxes in the cost of service since it is an annual cost to the Cobbs of owning the land. Annual maintenance costs were also included in the cost of service.[69]

On brief, Fairfax County supports Staff's adjustment.[70]

The Company counters that the Cobbs did incur a cost for the land, asserting that the land had an imputed cost of $175,000.[71] The Company also offered its 1984 real estate tax bill as

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[62]Ex. DAC-6.

[63]*Id.*

[64]Company Brief at 2.

[65]*Application of Reston Lake Anne Air Conditioning Corporation*, Order Granting Approval, Case No. PUA940052, 1995 S.C.C Ann. Rep. 189 (March 28, 1995).

[66]*Id.*

[67]*GTE South, Incorporated*, Case No. PUC950019, 1997 S.C.C. Ann. Rep. 216, 218 (hereinafter referred to as the "*GTE* case").

[68]Ex. LCM-7, at 7.

[69]*Id.*

[70]Fairfax Brief at 3.

[71]Tr. 81 – 83.

evidence that the land was valued at $94,265.[72] Mr. Cobb conceded that although the Cobbs have been given the authority to charge $15,600 in annual rent to the Company, "[w]e have rarely collected the rent."[73]

On brief, RELAC contends that Donatelli and Klein, Inc. agreed to provide capital to HOLDAC in the amount of $250,000 to compensate it for assuming the responsibility and liabilities of the utility operations. Mr. Cobb asserted that only $75,000 of the capital contribution was paid in cash and the balance was paid in the form of a transfer of the land upon which the plant was located. When HOLDAC was dissolved in 1986, the land was transferred to Mr. and Mrs. Cobb and the deed of transfer reflected a value of $94,265.[74] Mr. Cobb testified that they used the value upon which taxes were assessed rather than the $175,000 cost of acquisition to avoid an increase in real estate taxes. He also noted that the present tax assessment on the land is based on a fair market value of $141,395.[75]

Mr. Cobb also cites previous rate cases in which the expense of the lease has been approved in the Company's expenses without exception.[76]

Mr. Cobb argues that he gave up $175,000 in cash to have the land included in the deal and thus clearly there was a cost of his acquisition of the land. Moreover, he argues that in the *GTE* case, the Commission dealt with the reasonableness of charges paid by an affiliate for products and services that could be obtained elsewhere. In this case there are no market alternatives. The plant is permanently situated on the land and cannot be moved. Mr. Cobb asserts that the assessed value of the land is generally lower than the fair market value. Mr. Cobb argues that allowing no rent costs for the land would force him to sell it to a non-affiliate.[77] Finally, the Company argues that there is no evidence that the price the Company pays to the Cobbs for ground rent is contrary to the public interest.

Virginia Code §§ 56-78 and 56-79 specify and require that affiliate charges be in the public interest and supported by satisfactory proof. The Virginia Supreme Court has interpreted those statutes to be satisfied if a utility demonstrates that the costs are as reasonable as those obtained elsewhere.[78] However, it upheld an order of the Commission denying recovery of affiliate expenses because the utility failed to meet its burden of proof as to the reasonableness of those expenses. In that case, the Court stated that the utility had presented no evidence of comparative prices or

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[72]The Company also offered a letter from a realty company discussing the annual rental value of the subject property as Attachment 4 of Ex. DAC-2. Staff objected to its admission and the objection was taken under advisement. (Tr. 71). That objection is sustained since the Company did not offer a corroborating witness to support the letter. The letter thus is hearsay and cannot be accepted for the truth of the matter asserted.

[73]Tr. 118.

[74]Ex. DAC-3.

[75]Ex. DAC-2, Att. 5.

[76]Company Brief at 2; *Application of Reston/Lake Anne Air Conditioning Corporation*, Case No. PUE890085, 1990 S.C.C. Ann. Rep. 316; and *Application of Reston/Lake Anne Air Conditioning Corporation*, Case No. PUE940016, 1995 S.C.C. Ann. Rep. 299.

[77]Ex. DAC-2, at 2-3.

[78]*Commonwealth Gas Services, Inc. v. Reynolds Metals Company*, 236 Va. 362 at 367 (1988).

affiliate profits.[79] In another case, the Court stated that it did not "question the duty of the Commission to determine what expenditures by a telephone company for equipment are reasonable, and in so doing to determine if an affiliate supplier's profit margin is excessive or that the prices charged are higher than those charged by a competing supply company."[80]

In the more recent *GTE* case cited by Staff, testimony was offered to show that the charges *GTE* paid to an affiliate were as reasonable as the cost of the same data processing services obtained elsewhere in the open market. The affiliated companies had in fact made significant sales of such services to unaffiliated third parties and the growth in unaffiliated company sales had increased. GTE paid comparable or lower costs than the charges paid by unaffiliated third parties and therefore GTE had contended that the prices were reasonable. GTE also offered a study that showed the rates and service costs were among the lowest in the group of computer processing and application development vendors.[81] The study comparing the costs to services available in the marketplace was not challenged. In addition, Staff recognized that the affiliate prices were lower than those available in the marketplace.[82]

In its Final Order, the Commission, however, denied recovery of the level of expenses GTE incurred for goods and services provided to it by two of its affiliates because the company had not established that the charges were based on the affiliates' costs. The Commission held that:

> [T]he test of the reasonableness of any expense incurred by a utility in making such purchases can be simply summarized. Where it is most economical for the utility to purchase the product or service from an market, it should do so. Where it can save money by purchasing from an affiliate at the affiliate's cost, including a reasonable return for the affiliate on the sale, it should do that. Where the Company proposes that the Commission set rates based on charges from an affiliate, the charges must be based on the affiliate's cost, including a reasonable return, so long as this cost does exceed the market price. The market test applied by this Commission and the Court is to test whether the affiliate's costs are reasonable.[83]

The affiliate expense at issue in this case is much different than the expenses at issue in the *GTE* case. Moreover, and importantly, Staff bases its disallowance on its conclusion that the Cobbs received the land at no cost. To the contrary, the Company submitted evidence that the cost of the land was $175,000, the difference between the agreed $250,000 compensation to assume the litigation liability pending at the time of the transfer and to assume operation of the plant, and the

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[79] *Id.*

[80] Central Telephone Co. of Virginia v. State Corporation Commission of Virginia, 219 Va. 863 at 881 (1979) (emphasis added).

[81] *Application of GTE South, Incorporated*, Case No. PUC950019, Hearing Examiner Report at 35 (March 14, 1997).

[82] *Id.* at 35.

[83] *Application of GTE South Incorporated*, Case No. PUC950019, 1997 S.C.C. Ann. Rep. 216, 218 (August 7, 1997).

actual $75,000 cash received. Moreover, a deed transferring the property from Donatelli and Klein to HOLDAC reflects a cost of $94,265 for the property.[84] The real estate tax bill reflects the same 1984 value for the property.[85] I find evidence in the record supports the conclusion that the Cobbs did incur a cost for acquisition of the land.

Further, the Company cannot continue as a public utility without leasing the land upon which the plant is fixed. The lease is essential to provide the certificated public service, and clearly there are no alternatives in the marketplace. Hence, an adjustment should be made to recognize this asset.[86]

However, allowing an expense for rent in rates guarantees a return on the asset. As an alternative, Staff witness Miller suggested that the Commission could consider including the land in the utility's rate base at its 1983 assessed value for ratemaking purposes only. The Company would then be allowed an opportunity to earn a return on the land.[87] I support Staff's alternative recommendation. The land is used exclusively by the utility; there is no other use for it since the utility plant is permanently located on the land. It would be unreasonable to ignore that value or force the Cobbs to sell the land to an unaffiliated landholder that might hold the utility captive with no other options since the plant cannot be reasonably relocated. Staff's alternative suggestion recognizes the value of the land to the Company, but yet it does not guarantee a return on that asset. Such treatment offers a reasonable alternative to the all or nothing recommendations of Staff and the Company, and it should be adopted.

*Employee Benefits Expense*

Staff also removed reimbursements to the Company's employees for copayments for prescription drugs. Those costs were not covered by the Company's revised medical plan, and in Staff's opinion should not be included in rates. The Company takes exception to the Staff's adjustment. Mr. Cobb explained that the anniversary of the Company's contract for employee medical insurance was February 1 of the test period. At that time the Company elected to decrease the insurance expense by accepting copayments for prescriptions. Mr. Cobb testified that before the change the January bill for health insurance was $374.33, and after the change, the February bill $334.89, as were the bills for each succeeding month.[88] Mr. Cobb testified that the Company saved $433.84 in premiums during the test period (11 x $39.44) by opting to make copayments. The test period copayments totaled $262. The Company thus enjoyed a net savings of $171.84 for the test period even after making the copayments.[89] Therefore Mr. Cobb argued, the Company can and should reimburse the employees for the copayments as part of reasonable employee benefits.

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[84]Ex. DAC-3.

[85]Ex. DAC-4.

[86]Tr. 144.

[87]*Id.*

[88]Ex. DAC-2, at 2.

[89]*Id.*

Staff recognized that during the test period, the copayments were lower than the higher cost of insurance with no copayment; however, Ms. Miller observed that such a relationship may not always be the case.[90]

I agree with Staff's adjustments. It is not unusual for health insurance to require copayments. Reasonable costs of health insurance for employees are appropriately included in the cost of service, but employees' individual copayments are not. Such individual costs are simply not necessary costs of providing utility service. It is the Company's responsibility to provide utility service at reasonable costs, and employee benefits, and health care insurance specifically, affect rates. A fair balance between reasonable care available for employees and low costs for consumers must be achieved. Many companies contract for health care with copayments as an appropriate way to control costs. Thus I commend the Company for seeking revisions to control its costs. However, Staff's adjustment is reasonable, and should be adopted.

*Rate Design*

Fairfax County's witness, Ms. Gould, testified that she reviewed the Company's cost of service study. She agreed that the study supported allocating all of the granted increase to the metered customers; yet, she was concerned with the impact of the increase on those customers. She recommended allocating the increase to the metered class over a three-year period.[91]

Although the Company conducted a cost of service study, Staff also assessed the utility's costs of service. Staff allocated certain costs to the variable cost category that the Company did not include. Staff included the fuel costs of electricity and gas as well as additional costs associated with professional services, repairs and maintenance, transportation, water, gross receipts tax, and miscellaneous expenses. Staff found 41.7% of the Company's operation and maintenance expenses were variable.[92] That compared to the Company's classification of 28% of its costs as variable.

In rebuttal Mr. Cobb challenged Staff's cost of service study. He asserts that professional fees, repairs and maintenance, transportation, water and miscellaneous expenses are not variable costs. He asserts that professional fees include the costs of the Company's certified public accountant. He contends that repairs and maintenance are necessary for the plant to stand ready and are generally done in the winter. He argues that transportation is also necessary for servicing the plant. He further asserts that water must be bought to clean the plant, flush the toilet and make up lost volume for the system. Mr. Cobb asserts that it could be argued that even part of the electric bill should be classified as a fixed cost.

Staff accepted the Company's use of total BTUH load as the basis for determining the class allocation factors. Staff witness Stevens acknowledged that actual usage and demand, as recommended by Mr. Freeman and several public witnesses, would be preferable, but he testified no

[90]Tr. 144.

[91]Ex. DSG-10, at 3.

[92]Ex. JAS-8, at 8, and Att. 1.

usage data is available for the unmetered customers. Thus, in Staff's opinion total BTUH load is the only available basis for deriving cost allocators.[93]

Despite the differences between Staff's cost of service study and the Company's study, Staff agreed the metered rates are not producing sufficient revenue to cover even the fixed costs associated with serving those customers.[94] Staff, however, was concerned with the impact of the increase on the metered customers, and therefore supports Fairfax County's recommendation to phase in the rate increase and ease the rate shock.

Staff proposes to phase in rates over three years. Specifically, Staff proposes 40% of the increase in the first year, 30% in the second year, and 30% in the third year as follows:

| Year | Present Metered Revenue | Company's Proposed Increase | Percent Increase | Staff's Proposed Increase | Percent Increase |
|---|---|---|---|---|---|
| 1999 | $62,054 | $14,379 | 23.17% | $ 5,806 | 9.36% |
| 2000 | $76,433 | $10,784 | 14.11% | $ 4,355 | 5.70% |
| 2001 | $87,218 | $10,784 | 12.36% | $ 4,355 | 4.99% |
| Total | $98,002 | $35,948 | 36.68% | $14,516 | 14.81% |

Mr. Freeman argues that there is another basis for allocating costs.[95] He asserts that BTUH load does not measure the actual use of the chilled water produced by the Company. According to Mr. Freeman, at best, it is an approximation of potential maximum use.[96] He argues that such an allocation basis is inappropriate when actual usage is known. He urges the Commission to dismiss this case and in any future applications to base the cost allocation to the class of metered customers on the ratio of the actual gallons used by that class to the total gallons produced by the RELAC plant.[97] He also compared his own metered charges to the non-metered rate for his residence and extrapolated a reasonable allocation of any approved increase to all metered customers.[98]

The public witnesses also unanimously opposed application of the increase solely to the metered customers. They testified that metered use encouraged efficient use of the air conditioning service and further encouraged homeowners to take measures to improve the energy efficiency of their own homes. Many interpreted the Company's proposal as an attempt to force metered users to the fixed rate, and alleged that it actually encouraged waste.[99] Several urged the Commission to reject the application now pending.

[93] *Id.* at 8.

[94] *Id.*

[95] Tr. 165-166.

[96] Ex. MEF-11, at 2.

[97] *Id.*

[98] Ex. MEF-11, Att. 2.

[99] Tr. 8-48, 64.

As several witnesses observed, the restrictive covenants established the chilled air service in the area, and provide clear means for recourse if the majority of customers want to abandon the service and turn instead to more traditional individual units.[100] However, that issue is not before the Commission in this case. The Commission cannot declare RELAC customers free to install their own units in this case.

Of immediate import is the proper allocation of any increase that may be supported by the evidence. In the final analysis, Mr. Cobb, Staff, and Fairfax County agreed that the increase should be allocated to the metered customers, and Mr. Cobb further agreed with the phased approach recommended by Fairfax County and Staff.

Although I concur with Mr. Freeman's conclusion that it would be preferable to allocate costs based on actual usage, that data is not available on this record. I further cannot support his recommendation to dismiss this case because the Company has demonstrated a clear need for additional revenues. Staff opined that the BTUH load calculation is "adequate" for use in its cost of service study, and further testified that the metered rates are not producing sufficient revenue to cover even the fixed costs associated with metered service.[101] I therefore support allocation of the increase to the metered customers over three years as recommended by Fairfax County and Staff. The increase supported by my findings on the accounting issues discussed above is $22,411. Allocating 40% to the 1999 rates, and 30% in the two succeeding years results in the following:

| Year | Present Metered Revenue | Recommended Increase | Percent Increase |
|---|---|---|---|
| 1999 | $62,054 | $8,965 | 14.44% |
| 2000 | $76,433 | $6,723 | 8.80% |
| 2001 | $87,218 | $6,723 | 7.71% |

The public witnesses raised valid concerns about driving customers away from metered rates. Certainly flat rates provide no incentive to be energy efficient. I also agree with Fairfax County that metered service should not be discontinued. As the public witnesses all testified, metered service allows customers to pay for only that service that they want to take. It encourages energy efficiency and discourages waste. Metered service should be maintained. Further, the Company should be directed to provide its actual gallon usage to support any future applications.

[100]Tr. 18, 164.

[101]Ex. JAS-8, at 9.

## FINDINGS AND RECOMMENDATIONS

In conclusion, based on the evidence received in this case, and for the reasons set forth above:

1. The use of a test year ending December 30, 1997 is proper in this proceeding;

2. The Company's test year operating revenues, after all adjustments, were $300,775;

3. The Company's test year operating deductions, after all adjustments were $298,932;

4. The Company's test year operating income, after all adjustments was $1,843;

5. The Company's adjusted test period rate base, including the leased property discussed above, is $290,042;

6. The Company's current rates produce a return on adjusted rate base of 0.64%;

7. The Company requires an increase in gross annual revenues of $22,411;

8. That increase would provide the Company an opportunity to generate a return on rate base of 8.20% when fully implemented; and

9. The Company should file permanent rates designed to produce the additional revenues phased in over a three year period as it agreed to and as found reasonable herein.

In accordance with the above findings, I ***RECOMMEND*** the Commission enter an order that:

1. ***ADOPTS*** the findings in this Report;

2. ***INCREASES*** the Company's authorized gross annual revenue by $22,411; and

3. ***DIRECTS*** the refund of any amounts collected under the interim rates in excess of the rate increase found just and reasonable herein.

## COMMENTS

The parties are advised that any comments (Section 12.1-31 of the Code of Virginia and Commission Rule 5:16(e)) to this Report must be filed with the Clerk of the Commission in writing, in an original and fifteen (15) copies on or before August 6, 1999. The mailing address to which any such filing must be sent is Document Control Center, P.O. Box 2118, Richmond, Virginia 23218. Any party filing such comments shall attach a certificate to the foot of such document

certifying that copies have been mailed or delivered to all counsel of record and any such party not represented by counsel.

Respectfully submitted,

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Deborah V. Ellenberg
Chief Hearing Examiner